October 31, 1991

COORDINATED ISSUE
MOTOR VEHICLE INDUSTRY
EXCESS PARTS INVENTORY

ISSUE

Whether surplus and obsolete material transferred at a loss as part of a purported sale to an unrelated warehouse facility, in prior years that are now closed by the statute of limitations, constitutes inventory for the current year where the taxpayer has retained dominion and control.

FACTS

Motor Vehicle Industry manufacturers and distributors maintain extensive inventories of replacement parts and components to service customers future needs. These companies generally have policies stating how long replacement parts will be retained and frequently they retain them for longer periods.

When parts or components are manufactured or purchased from vendors, it is more economical to order a large quantity sufficient to meet current demand and anticipated replacements than to order a smaller quantity for current demand and then order again for replacement demand. Consequently, the items ordered for future replacement demand may be held for many years before being sold, and may eventually be scrapped. Because of a long retention period and the possibility that the parts might eventually be scrapped, they are commonly referred to as "excess parts."

Prior to the Supreme Court's Thor decision, (Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979), 79-1 USTC, Par. 9139) excess parts were routinely written down by manufacturers to their net realizable value based upon management's business experience and forecasts of future demand. This method met the requirements of generally accepted accounting principles (GAAP) and resulted in the value of the parts in inventory to be a fraction of their historical cost or having no value at all. The Supreme Court held that taxpayers with excessive parts inventories could not value them based on future demand even though the method was permissible under GAAP. The Court ruled that the parts should be valued at historical cost where "market" could not be ascertained and they were not scrapped.

Faced with the alternatives of either inventorying the replacement parts at cost or scrapping them, taxpayers made arrangements to "sell" their excess parts to warehousing companies at scrap prices with the understanding that the parts would remain under the taxpayers' control. Taxpayers account for these "sales" by including the scrap sales price in income and deducting, through cost of goods sold, the historical cost of the parts. The net result is a loss similar in amount to the deductions previously claimed by writing down the inventory value of the excess parts.

As part of the arrangements with the warehousing companies, taxpayers do not surrender all burdens and benefits of ownership but continue to exercise control so as to remain the exclusive source of the parts for their customers. These arrangements provide for buy-back or similar provisions, either stated or implied. Thus, taxpayers are able to continue to fill customers' orders for the parts even after the parts are "sold" to the warehousing company. Taxpayers intend to circumvent the Court's Thor rule through these arrangements.

Taxpayers in the Motor Vehicle Industry have transferred excess parts to warehousing companies for many years since the Thor decision, and deducted losses on the "sales" during years for which the statute of limitations has expired. The parts, however, continue to be maintained by the warehousing companies but are not included in the taxpayers' inventories.

LAW

In Paccar Inc. and Subsidiaries v. Commissioner, 849 F. 2d 393 (9th Cir., 1988), 88-1 USTC Par. 9380, and Clark Equipment Company and Consolidated Subsidiaries v. Commissioner, T.C. Memo 1988-111, the courts have held that no deduction is allowable for losses based on sales of excess parts where the taxpayer retains a degree of control over the use and disposition of the parts. The manufacturer's control over an inventory of parts "sold" to a warehouse is equivalent to ownership. It was agreed that the warehouse would not sell the parts to anyone other than the manufacturer, who also had an exclusive right to repurchase those parts. The court stated in PACCAR:

> In our view, the following four factors should be considered in determining the character of the transactions between petitioner and SAJAC: (1) who determined what items were taken into inventory; (2) who determined when to scrap existing inventory; (3) who determined when to sell inventory and (4) who decided whether to alter inventory.
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> In the instant case, we conclude that the transaction between petitioner and SAJAC did not constitute a sale because petitioner retained dominion and control over the assets transferred to SAJAC for at least 4 years after the initial transfer. During this period, SAJAC was required to retain the inventory transferred. As a matter of practice, the inventory was retained for a longer time. Not only was SAJAC unable to dispose of the assets for at least 4 years, but,

> even after that period expired, when SAJAC requested permission from petitioner to sell the inventory it was not permitted to sell it in usable form. Petitioner also retained the right to require SAJAC to destroy, scrap, dismantle, or mutilate the material not resold to petitioner. In effect, petitioner retains the same control over the inventory that it had before shipping it to SAJAC. The only right SAJAC had with respect to the inventory was to receive an agreed amount for any item petitioner had shipped to a dealer for use as a part. In effect, this payment was no more than a flexible storage fee. ...the record reflects that petitioner sent inventory to SAJAC as a matter of course in order to retain the parts for future shipment to dealers, but at the same time to attempt to achieve tax benefits as if the inventory had been sold.
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> In our view, the transfer of excess and obsolete inventory from petitioner to SAJAC did not constitute a sale but was a device to circumvent our holding in Thor Power Tool Co v. Commissioner, supra, which was affirmed by the Supreme Court.

Rev. Rul. 83-59 holds that a manufacturer may not reduce its ending inventory based on purported sales of "excess" inventory at scrap value, when under the sales arrangement the manufacturer continues to possess, as a matter of fact, the benefits and burdens of ownership with respect to the "excess" inventory. This type of transaction is not a bona fide sale for federal income tax purposes.

Section 1.471-1 of the Regulations provides that inventory should include all goods where title vests with the taxpayer.

Section 446 IRC provides that when a taxpayer's method of accounting does not clearly reflect income, a method that does clearly reflect income may be used to compute income. Regulation 1.446-1(a)(1) states that a method of accounting includes not only the over-all method of accounting but also the treatment of any material item.

Section 481 IRC provides the rules to be followed when income is computed under a method of accounting that is different from the method previously used. Section 481(a) IRC requires adjustments necessary to prevent amounts from being duplicated or omitted by taking them into account when an accounting method is changed. These adjustments distort income since they include amounts accumulated during years under the old method of accounting.

Rev. Proc. 84-74, 1984-2 C.B. 736, sets forth the procedures to be followed when a method of accounting is changed, and provides for an adjustment period, under certain conditions, to ameliorate the distortive effect of the Section 481(a) adjustments. However, the provision providing for an adjustment period does not apply to a change from a so-called Category A method of accounting after the taxpayer has been contacted to schedule an examination of the return(s) which utilizes the Category A method. Rev. Proc. 84-74, supra Sec. 4.01(2). In this case the Section 481(a) adjustment will be taken into account for the year under examination for which the change in method is made.

Category A methods of accounting are methods that are not permitted to be used by the Code, regulations, or by a decision of the Supreme Court. Specifically included in this definition are Thor Power Tool type cases where a taxpayer writes down excess inventory. Rev. Proc. 84-74, supra at Sec. 6.02, Ex. (4).

DISCUSSION

If a taxpayer transfers excess parts to warehousing companies during a year under examination and deducts a loss on the transfer, the loss can be disallowed using the principles established by Rev. Rul. 83-59 which have been affirmed by the courts in PACCAR and Clark.

Taxpayers may have transferred excess parts to warehousing companies in prior years and deducted losses on the "sales", and these losses may not have been disallowed for the years claimed because the year of the loss was not examined or the issue was not raised. The statute of limitations for assessing additional tax for these years may have expired.

Under the principles established by Rev. Rul. 83-59 and the courts in PACCAR and Clark, the excess parts should be included in inventory if they are being held by the warehousing company even if they were transferred in prior years. For any current year under examination, the issue should be raised to include the excess parts in inventory similar to other situations where taxpayers have not included items in inventory.

When a taxpayer has used an improper method of accounting for tax purposes, a change to a correct method may be made during a current year under examination. Thus, if taxpayers have excluded items from inventory for a number of years, a change can be made to include in the current inventory all items improperly excluded. The rules of Section 481 and Rev. Proc. 84-74 should be applied.

CONCLUSION

Any excess parts that have been transferred to a warehousing company are includible in inventory where the taxpayer retains dominion and control over the parts. If the parts have been excluded for a number of years, a catch-up adjustment should be made to include them in the current year's inventory.